EUROPEAN CENTRAL BANK

THE NEW BASEL CAPITAL ACCORD REPLY OF THE EUROPEAN CENTRAL BANK TO THE THIRD CONSULTATIVE PROPOSALS (CP3)

On 29 April 2003 the Basel Committee on Banking Supervision (BCBS) issued its third consultative proposals (CP3) on the New Basel Capital Accord asking for comments from all interested parties by 31 July 2003. This note, which benefited from comments provided by the Banking Supervision Committee, contains the contribution of the European Central Bank (ECB) on the matter.

In line with its previous contributions,[1] the ECB remains *very supportive* of the work being undertaken by the BCBS and *reiterates its endorsement* of the general thrust of the proposed framework. In general, the ECB notes that the third consultative proposals mark significant progress relative to the previous proposals of the BCBS. The improvements include, inter alia, the flattening of the risk weight curves for internal ratings based (IRB) approaches, the treatment under Pillar II for banks using the IRB approach to address pro-cyclicality concerns, the treatment of banks' exposures to small and medium-sized enterprises (SMEs) and retail exposures, and the revised proposals for operational risk for banks or banking systems experiencing high credit margins.

This note is organised in two parts. The first part contains remarks of a general nature mainly from the viewpoint of financial stability, while the second addresses specific technical issues.

General remarks

The general comments are divided into three parts. First, issues warranting consideration when finalising the New Accord. Second, issues warranting enhanced monitoring in the first phase of implementation of the new framework. Third, suggestions for topics related to the New Accord on which the BCBS could work in the future.

(I) Issues warranting consideration when finalising the New Accord

First, the ECB considers it to be of the utmost importance that the current schedule for finalisation and implementation of the New Accord be strictly followed. A timely finalisation by the end of this year would maintain confidence in the New Accord and the credibility of the process. In addition, once agreed upon and published, the New Accord should not be subject to major revisions until at least the implementation of the rules, envisaged at the end of 2006. This is consistent with the prudent policy followed by the BCBS so far and will also allow banks to develop their investment plans and risk management procedures in view of the implementation of the New Accord.

Second, the ECB welcomes the proposals to tackle the potential pro-cyclical effects of the new capital adequacy regime. In addition to the flattening of the risk weight curve, the proposed introduction of stress tests and the development of capital buffers above the minimum capital requirements within Pillar II are steps in the right direction. The ECB has supported the need for considering the potential pro-cyclical impact of the New Accord since the early stages of the BCBS's proposals.[2] In this context, the ECB and other euro area central banks have consistently contributed to the supervisory debate by complementing the discussion with a

1 The ECB provided comments on the first and second consultative proposals released by the BCBS in June 1999 and March 2001 respectively.

2 See the ECB comments on the CP2 which can be found at the website of the ECB (http://www.ecb.int) under publications "The New Basel Accord: comments of the European Central Bank", June 2001.

macroeconomic dimension to supervisory tools and practices. Concerns about pro-cyclicality of the New Accord might be increased in an environment of deeper economic and financial integration since vulnerabilities and cycle swings could become more synchronised. However, the ECB also realises that pro-cyclical effects cannot be reduced at the cost of a major misalignment between regulatory and economic capital and of a loss of integrity and "signalling power" in internal risk-management systems. With regard to the latter, the ECB understands that one of the major innovations of the new rules is to provide regulators with a new information tool through IRB systems. Against this background, the ECB sees merit in strengthening possible steps to alleviate the potential pro-cyclical impact of the New Accord. More specifically:

- The current text concerning the supervisory review of stress tests for banks under the IRB approach (paragraph 724) could be improved. In particular, the supervisory review of banks' stress tests would appear to be optional under the proposed wording, which states that "supervisors may wish to review how the stress test has been carried out". A firmer statement that "supervisors should review how the stress tests have been carried out", namely when reviewing large systemically relevant banks, would thus be welcomed. This is also consistent with the agreement reached in the BCBS on 10 July 2002. In particular, the public release on the aforementioned agreement states in the section on stress testing that "banks and supervisors will use the results of the IRB stress tests as a means of ensuring that banks hold a sufficient capital buffer under the IRB approach". The ECB considers the supervisory review of profound importance for ensuring a prudent application of this requirement.

- The ECB continues to support the building-up of additional financial buffers[3] in favourable economic times which can be used in less favourable economic conditions when, inter alia, equity financing may be more difficult to obtain on the markets. The counter-cyclical effect of such methods could be acknowledged by making an explicit reference to them in the text of Pillar II.

- There could be cases in which supervisors might require banks opting for the standardised approach to hold additional buffers against pro-cyclical fluctuations. The risk weights currently proposed under the standardised approach may render the capital requirements more sensitive to cyclical conditions. One "extreme case scenario" can be represented by the example of a bank with highly concentrated exposures to corporate credits, where a downgrade by one notch[4] from A- to BBB+ would lead to a doubling of capital requirements. It may be argued that such cases would be limited in that internationally active and other important domestic banks would opt for the IRB approach or would hold diversified portfolios.

Third, the ECB takes the view that some improvements could be still introduced in relation to the correct incentives for banks to opt for more sophisticated approaches. In the area of credit risk, as the Third Quantitative Impact Study (QIS 3) results indicate, the incentive structure has been significantly improved relative to the second consultative proposals thanks to the recalibration of the IRB approach and the revision of the risk weights. However, in the case of lower quality credits, it is envisaged that the capital requirements calculated according to the standardised approach will be substantially lower vis-à-vis the IRB approach and, presumably, this gap is likely to increase as the credit quality decreases. This might create incentives for banks with a higher risk loan portfolio to adopt the

3 *One way of building such buffers is through the expanded use by banks and supervisors of pro-active provisioning methods such as "dynamic provisioning".*

4 *Examples are based on the ratings used by the BCBS in the proposed New Accord.*

standardised approach. This argument is reinforced by the more beneficial capital impact for the G10 international banks under the IRB approach versus the standardised approach, according to the last QIS 3 survey.[5] This issue might be addressed, for instance, by requiring additional capital requirements for those banks whose capital is not commensurate with their risk profile. Also in the field of operational risk there still seems to be scope for improvements in the incentive structure, in particular in the calibration of the basic indicator and the standardised approach (see also the specific remarks below).

Finally, two issues relating to the common implementation of the New Accord, effectively to ensure a level playing-field on a global scale. First, there is the need to ensure a harmonised implementation of the new framework in G10 countries. For example, the US authorities have made clear that they intend to apply the new rules only to the largest, internationally active commercial banks and will require them to use only the advanced methodologies for credit and operational risk. In this respect, in case the United States does not provide for the implementation of less advanced approaches, the treatment of EU banks operating in the United States via subsidiaries should be further clarified. Although more recently the US authorities have demonstrated a positive attitude towards exploiting options for resolving implementation issues for foreign banks operating in the United States,[6] this flexibility has not been reflected in the Advance Notice of Proposed Rulemaking (ANPR) released in July 2003 for consultation by the US authorities. It is expected that some options for resolving implementation issues for foreign banks operating in the United States will be introduced in the final rules. Second, there is the breadth of implementation of the New Accord in non-G10 countries. If the New Accord is intended to remain as an international standard for capital adequacy around the world, it is crucial that the new framework, and especially the simpler approaches of the consultative proposals, enjoys the support of the vast majority of non-G10 supervisors as well as of the International Monetary Fund (IMF) and the World Bank.[7] In this regard, it may be deemed appropriate for non-G10 countries to extend the implementation of Basel II for developing countries beyond the end of 2006. However, possible delays in the implementation of Pillar I rules should not prevent supervisors in these countries from implementing key components of the supervisory review (Pillar II) and market discipline (Pillar III). In addition, thorough implementation guidance developed by the BCBS for non-G10 countries, to be endorsed by the IMF and World Bank, would be an efficient tool in facilitating the transition of these countries to the New Accord.

(II) Issues warranting attention in the implementation phase

The New Accord is a complex framework in comparison with the current one. A full understanding of all its possible implications will be possible only some time after implementation. For this reason, close monitoring of the application of the new regime will be important. In this regard, four issues can be highlighted.

First, in drawing up the agreement, the emphasis has been rightly placed on the implications of the New Accord for risk management and financial stability. The New Accord, however, is also set to have important structural implications for banks and banking systems through changing bank behaviour. The very diverse effects on capital

5 *QIS 3 – overview of global results, Table 1 on world-wide results – overall percentage change in capital requirements.*

6 *See, for example, "Basel II – scope of application in the United States", a speech given by Mr. Roger W. Ferguson Jr., Vice Chairman of the Board of Governors of the US Federal Reserve System, before the Institute of International Bankers in New York on 10 June 2003. In the speech it is stated that "the US supervisors are prepared to explore the possibility of allowing US subsidiaries of foreign banks to use conservative estimates of LGD and EAD for a finite transitional period".*

7 *Both as overseers of the well-functioning of supervisory standards and codes in the context of the Financial Sector Assessment Programs.*

requirements for individual banks triggered by the New Accord[8] are likely to influence their business strategies through, for example, mergers and acquisitions, a reallocation of their loan books (e.g. through credit risk transfers or a restructuring of existing transactions), an increased specialisation on products and/or counterparties with a particular risk profile and a restructuring of retail banking activities in the form of revolving exposures. These structural changes will also have to be monitored closely from a central bank perspective.

Second, pro-cyclicality concerns could be particularly relevant in the first phase of the implementation of the new framework when banks are adjusting to the new setting[9]. This may require closer monitoring by central banks and supervisory authorities so that potential problems can be detected and addressed in a timely fashion. Enhanced corporate governance by banks will also be an important complement to the activities of public authorities in ensuring a smooth transition to the new regime.

Third, in the area of real estate lending the ECB has no objection to the new and more flexible treatment proposed under both the standardised and IRB approaches. However, it cautions that the extended recognition of real estate collateral should not lead to excessive real estate lending and an overheating of property markets. This entails a need for prudent valuation by banks to prevent increases in credit availability from fuelling asset price bubbles for residential and commercial properties.

Fourth, in the area of credit cards, the proposed reduction in regulatory capital is significant and, for some banks at least, will determine a level of regulatory capital well below the economic one. Under these circumstances, it is emphasised that excessive lending to retail customers via credit cards, especially in periods of booming economic activity, may lead to undesirable macroeconomic effects, such as increased consumer spending and increased household debt. In addition, the particularly low capital requirements for revolving retail exposures relative to similar types of unsecured personal consumer loans may have structural implications as banks could be induced to structure retail banking in the form of revolving exposures.[10] This may hold true in particular in EU countries where unsecured consumer loans and other similar types of exposures are widely used in addition to credit cards. An expansion of the latter type of credit could have implications for banks' risk management as the mix of their risks could change (note the relative importance of operational risk for credit card based exposures). Also, the low loss rates and subdued volatility for credit cards seem to be a characteristic of the more mature US market. All the above elements suggest a need for enhanced vigilance and close co-operation between central banks and supervisory authorities in the implementation phase.

(III) Future work on issues related to the New Accord

The revision of the capital adequacy regime, put forward by the BCBS, has focused on improving risk measurement. In order to maintain the effectiveness of the overall approach in the long run, it will be necessary for the BCBS to initiate work at some stage on other related issues. With a view to contributing to the definition of the future work programme of the BCBS, the ECB sees priorities in the following areas:

- Accounting and provisioning. The pursuit of greater consistency in accounting and

8 On the basis of the QIS 3, the impact of the IRB approach on individual banks varies significantly from a 46% increase in capital requirements to a 36% decrease.

9 For the calibration of absolute capital requirements for the New Accord a full business cycle should preferably be taken into account. Notwithstanding the fact that the current state of development in banks' rating systems would not technically allow the pursuit of capital requirements from a full business cycle perspective, it cannot be disregarded that the capital requirements that resulted from the QIS 3 were affected by the "point-in-time" ratings that tend to prevail in many banks' internal ratings assessments, and thus by the particular phase of the economic cycle.

10 This is acknowledged by the BCBS (overview paper, paragraph 76).

provisioning rules across countries has become an increasingly important goal in the context of a risk sensitive capital framework. Greater consistency will promote competitive equality, allow better cross-border comparisons, reduce the reporting burden and reinforce the effectiveness of Pillar III. In this context, it would be of interest to further align International Accounting Standards (IAS) with Basel II. The ECB therefore supports the initiatives being undertaken by the BCBS to co-operate with accounting standard setters, namely the International Accounting Standards Board (IASB), to ensure that supervisory concerns are taken into due consideration in the shaping of the new standards and that there will be no need for divergent accounting and regulatory standards. For the latter, common standards for aspects such as the definition of default and the assessment of impaired assets are of primary importance in order to reduce the reporting burden of banks and to ensure consistency between accounting and risk management procedures.

- Definition of own funds. There is room for further harmonisation of the definition of own funds, especially for innovative capital eligible as Tier 1 or Tier 2, and for greater consistency in current supervisory practices for accepting instruments with step-ups.

- Supervisory practices. The new framework entails increased emphasis on supervisory convergence in order to assure a "level playing field" between individual banks and banking systems. In the EU, work on convergence has gained momentum in the context of the new institutional setting following a political agreement reached at the Council of Finance Ministers in December 2002 to extend the so-called "Lamfalussy framework", which is already in place in the securities field, to other financial sectors. In the EU banking sector, work on the convergence of supervisory practices has already been set in motion by the Groupe de Contact (GdC) and is anticipated to be a major responsibility of the forthcoming European Committee of Banking Supervisors (ECBS). At the G10 level, convergence efforts are being made via the Accord Implementation Group (AIG). Given that, at this juncture, the mandate of the AIG is mainly confined to the exchange of information among supervisors, merit is seen in encouraging the AIG to intensify its efforts in pursuing a coherent cross-border implementation of the New Accord. This effort would, of course, have a positive impact on the corresponding work carried out in the EU context.

Specific remarks

This section contains comments on more technical aspects of the proposals to be taken into account mainly with a view to the finalisation of the New Accord.

Scope of application

The proposed deduction of investments, namely 50% from Tier 1 and 50% from Tier 2, should be clarified in the final proposals by, for instance including an example in an annex, as is the case with Tier 1 limits in Annex 1 of the CP3. More specifically, it should be made clear whether the proposed deduction should follow the current rules (i.e. the deduction should take place after the calculation of Tier 1 and Tier 2 components of capital) or should be applied before arriving at the final figures.

Standardised approach

The proposed preferential treatment of claims on sovereigns, namely the lower risk weight to be applied at the discretion of national authorities to banks' exposures to the sovereign of incorporation denominated in domestic currency and funded in that currency, is not subject to any limitations. This leaves ample scope for national discretion. Accordingly, the current broad-brush rules on claims on sovereigns denominated in domestic currency remain unaffected and the element of credit risk for domestic funded exposures is completely disregarded. A more stringent treatment at least for low credit quality sovereigns may encourage prudent lending policies by banks to the sovereigns in question. In this context, it should be noted that the ECB pursues a policy of equal treatment of public and private issuers in its own operations.

With regard to claims on multilateral development banks (MDBs), the ECB supports the more flexible drafting of the second eligibility criterion and the underlying argument that the criterion of relying on shareholders' creditworthiness to repay liabilities becomes less relevant when there is no leverage. However, as the evaluation of MDBs will continue to be made on a case-by-case basis by the BCBS, it may be preferable to list in the text[11] (paragraph 33) the MDBs currently eligible for a 0% risk weight, as in the case of claims on international institutions (paragraph 30). More generally, an update of the list of MDBs eligible for a 0% risk weight, together with the eligibility criteria, would be a more workable and practical solution than the current exhaustive reference to the eligibility criteria to be applied by the BCBS.

Regarding the treatment of claims on banks, the need to remedy possible implications of the existence of the two options requires enhanced co-operation. Indeed, the freedom which jurisdictions have to choose between the two options to claims on banks contained in the standardised approach could have undesirable consequences. For example, an unrated or poorly rated bank operating in a G10 jurisdiction which adopts Option 1 could benefit from a lower risk weight than a highly rated bank in a jurisdiction, which adopts Option 2. Supervisory co-operation could therefore play an important role in ensuring a level playing field in cases where different jurisdictions adopt different options.

The eligibility criteria for external credit assessment institutions (ECAIs) could be further strengthened, making the requirements more binding, while specific considerations may need to be taken into account when considering the structure of the highly concentrated rating business. The interest of the ECB in this matter derives not only from the fact that it follows its own policy with regard to the eligibility of collateral for monetary policy operations and of investments for asset management operations, but also from its role in maintaining financial stability. First, the ECB believes that the assessment of new ECAIs should be done in a prudent fashion, taking into account the fact that some elements that may affect the assessment process, such as revenues and market share, may be valid for the existing international ECAIs but could create potential barriers to the entry of new players. For new players, less emphasis should be placed on market coverage and more on criteria relating to the robustness and soundness of the assessment methodology and rating procedure. In addition, for these players, ex-post accuracy and validity of ratings cannot be fully assessed due to the lack of sufficiently long data series (a rigorous and meaningful validation process would require many years of historical data). Second, in the aftermath of recent financial events, the following issues may require further reflection in the context of the rules on eligibility criteria (paragraph 61):

- The assessment of the ECAI's independence in respect of corporate governance issues may need to be more specific, namely by making explicit reference to the need to prohibit the staff and directors of rating agencies from being members of the governing bodies or supervisory bodies of rated firms.

11 MDBs are mentioned in footnote 15 of the consultative proposals.

- Rating agencies should implement procedures to manage potential conflicts of interest that arise, such as from ancillary fee-based business and direct contacts between analysts and subscribers.

With regard to the implementation of the mapping process (Annex 2) under the standardised approach, the proposed three-year cumulative default rate (CDR) benchmarks appear to be too generous. There is a need for further clarification of the distribution assumptions made in the Monte Carlo simulations performed to derive the proposed trigger levels. Experience of recorded long-run average CDR from international rating agencies implies that levels should be lower than the ones proposed. However, it is acknowledged that the proposals are intended to provide guidance to supervisors and not additional eligibility criteria for ECAIs.

Credit risk mitigation

The inclusion of non-rated debt securities as eligible financial collateral requires market liquidity. In this context, the requirement set forth in paragraph 116 (d), which focuses on supervisors having sufficient confidence about market liquidity, could be changed and made consistent with paragraph 96, which emphasises the liquidation properties of the assets and the liquidation procedures.

On the proposed standard supervisory haircuts (paragraph 122), the risk of collateral could be better reflected in the distribution of residual maturities by using more than three buckets. This is especially true for the bucket for maturities exceeding 5 years in which collateral with very diverse maturities are lumped together. In this regard, it would be desirable to divide the maturity bucket into two buckets, one for maturities between 5 and 10 years and another for residual maturities of more than 10 years.

Guidance on the criteria for classifying transactions as (i) repo-style, (ii) other capital-market driven transactions or (iii) secured lending would promote consistent implementation of the definition of holding periods (paragraph 137). With regard to the minimum holding periods required for calculating own estimates of haircuts (paragraphs 128 and 138) with a daily mark to market valuation or with daily remargining of the collateral, it is not clear why the minimum holding period is dependent on the transaction type (i.e. repo, other capital transaction or secured lending). The minimum holding period should be independent of the transaction type and, instead, be dependent on the liquidation characteristics of the collateral involved (i.e. the time required to sell the collateral in an orderly fashion in the market).

Finally, the reference to “reasonable steps” that banks should take to ensure that the custodian segregates the collateral from its own assets (paragraph 97) should be either clarified or, preferably, deleted, in which case the paragraph would simply require banks to ensure that the custodian segregates the collateral from its own assets.

Internal ratings based approach

The proposed rules for adopting a phased roll-out by banks with a view to extending the IRB approach across the entire banking book (paragraphs 225 to 231) include several exemptions subject to materiality conditions which are not further defined. These exemptions refer to non-significant business units, asset classes or sub-classes in retail as well as equity exposures. The introduction of materiality thresholds, or at least a general indication in the final rules of the amounts that the BCBS would consider to be potentially eligible for exemption, would promote consistency in implementation and a level playing field. In addition, a situation could arise where an immaterial exposure at the group level is significant within a local banking system. Hence, the exclusion of an exposure could be made subject to prior enquiry to the host country in order to ascertain the relative significance of the exposure. Furthermore, the data used in order to determine the banks' own estimates (Probability of Default, Loss Given Default and Exposure At Default) may be relevant at the group level but not at the local level. Hence, it may be useful to ensure the relevance of the characteristics of the own estimates by imposing the condition that banks' own estimates used locally should reflect local characteristics.

There seems to be an imbalance between the exhaustive but necessary list of minimum requirements that banks should comply with in order to be eligible for the IRB approach (paragraphs 349 to 500) and the assessment and action to be taken in cases of non-compliance. With regard to the latter, only very general references to situations that might lead to supervisory action, using phrases such as "not in complete compliance", "timely return to compliance plan" and "duration of non-compliance", are found in a single paragraph (paragraph 355). More guidance on these issues would promote consistent implementation. Alternatively, the AIG should address these issues.

There are some elements of the proposals that make sense from a functional point of view to ensure that banks' practices are properly taken into account when laying down the rules on compliance with minimum requirements. However, these elements need enhanced monitoring to ensure a level playing field and a prudent outcome when estimating capital charges. Against this background, the permission for banks to use human judgement to correct the rating outcome of credit scoring models (paragraph 379) or to override the outputs of the rating process (paragraph 390) is welcomed as a potential means to improve the overall process. In this context, a reference would be welcomed to the need for a periodic review by internal and/or external auditors of the practices of banks where human judgement has been allowed to override the rating generated by the model. In addition, banks should be ready to demonstrate prudent use of human judgement in their models' ratings whenever requested to do so by supervisory authorities or in the context of periodic reviews.

The time horizon used in probability of default (PD) estimations is set at one year (paragraph 376). A reference to the fact that the BCBS will monitor developments in risk modelling and banking practice with respect to the assessment horizon would be desirable. A sentence could be added in the text stating that the BCBS may revisit its requirements on the assessment horizon. This would also put the aforementioned references to prudent PD valuations into context.

The use of stress tests (paragraphs 396 to 399) is welcomed as a step towards ensuring capital adequacy under adverse economic, market and liquidity conditions. The ECB would support a reference to the fact that, in addition to the already mentioned follow up at the national level (paragraph 399), the BCBS will monitor developments in the field of stress tests and may come up with more concrete guidance, if required. In the same vein, an explicit reference to the results of stress tests could be made in the context of the internal rating reporting to senior management (paragraphs 401 and 402, section on corporate governance and oversight).

The proposed treatment of specialised lending and its five sub-classes (paragraphs 187 to 196, 218 to 220 and 244 to 253), although detailed, seems to leave open issues such as the assessment of restructuring by banks in distressed situations, which may in turn have level playing field implications as the risk weights of the "weak" and "default" categories differ significantly (350% versus 625%, respectively, for all sub-classes).

The reference to the application of the default rate for retail exposures at the level of the facility rather than at the level of obligor, and to the fact that a default by one borrower on one obligation does not require a bank to treat all other obligations to the banking group as defaulted (paragraph 417), makes sense from a functional point of view. However, a default by a borrower on one obligation may in practice also signal defaults on other obligations across the banking group. Thus it is proposed that there be an explicit reference to recognise the fact that banks will be allowed to make their own assessments and that supervisors will review them.

The treatment of previously defaulted exposures as non-defaulted and their possible subsequent reclassification as second defaulted exposures (paragraph 419) could be complemented by a reference to the need for prudent internal procedures by banks, including reviews by the internal or external auditors and their ability to demonstrate prudent treatment to their supervisors. In the same vein, the re-ageing of facilities and granting of extensions, deferrals, renewals and rewrites to existing accounts (paragraph 420) may require guidance from the BCBS with a view to promoting consistency in banks' practices.[12]

With regard to the length of the underlying historical observation period (i.e. 5 years), it is stated that, if the available observation period spans a longer period, the latter must be used (paragraph 425). However, it is not clear that long series of historical data would always be more appropriate because of changes in the portfolio base, rating methodologies or economic circumstances. A bank should not have to give equal importance to historical data if it is possible to demonstrate that recent data are more useful for the estimation of risk parameters.

On the mitigating effect of guarantees (where own estimates of LGD are used) two options are given, an adjustment of the PD estimate or an adjustment of the LGD estimate (paragraph 442). It is not clear why the adjustment should concern the PD, or the borrower's specific risk. The adjustment should be confined to the LGD, which takes into account transaction-specific risks. This would also make the adjustment consistent with paragraphs 359 and 393.

The rule stating that a bank cannot assign an adjusted PD or LGD to the guaranteed exposure if the adjusted risk weight would be lower than that of a comparable direct exposure to the guarantor (paragraph 444) may be overly stringent. A prudent move towards a more risk-sensitive approach could be considered in this context, based on further research on the risk mitigation of "double default".

The wide recognition of types of eligible guarantors[13] which is unlimited for banks under the advanced IRB approach (paragraph 445), including the recognition of conditional guarantees (paragraph 446), may warrant attention, given the fact that the application of the "w" factor, which may in practice limit the number of potential guarantors other than financial institutions, is no longer found under Pillar I. An undue proliferation of guarantees provided by non-banks, and especially by non-regulated entities which are not subject to capital requirements, may require close monitoring, as it may have an adverse impact on the level playing field and could give rise to reputational risks concerning the provision of guarantees in general. The ECB would welcome close monitoring by the BCBS of the possible implications of such wide recognition of guarantees by non-regulated entities and a possible future review of the proposals. The introduction of limitations may also be seen from a point of view of overall consistency, as the provision of insurance as a mitigant for operational risk is limited to insurance providers (which already are regulated financial institutions) with minimum credit rating of "A" or equivalent.

With regard to the recognition of other physical collateral, it is stated that each

12 The current text (paragraph 420) makes reference to the fact that some national supervisory authorities that may issue specific requirements.

13 The range of eligible guarantors/protection is also generous under the standardised and foundation IRB approaches and includes sovereigns, Public Sector Entities, banks and securities firms with a lower risk weight than the counterparty and other entities (including corporates and insurance companies) rated "A" or better.

supervisor should determine whether or not collateral meets certain standards, such as the existence of well-established liquid markets and publicly available market prices (paragraph 484). Although supervisors are in a privileged position to assess the liquidity of markets, this may not always be feasible given the nature of some types of collateral (e.g. inventories such as raw materials, goods, etc.). Accordingly, a reference could be added that banks should utilise available information from other competent bodies and authorities and should be able to demonstrate to their supervisors that their analysis is based on a prudent evaluation of such information.

With regard to the supervisory slotting criteria for specialised lending (SL), banks are expected to map their internal ratings based on their own criteria according to five categories (paragraph 374). Annex 4 provides general assessment factors for each sub-class of SL exposure. With a view to promoting a level playing field, further guidance on the way this mapping should be performed seems to be warranted for two reasons. First, there is the complexity of the mapping process, as the proposed tables with supervisory rating grades introduce numerous indicators (e.g. 18 indicators for object finance) that are to be classified according to four assessment categories, namely strong, good, satisfactory, and weak. Second, there is the generalised nature of some of the elements against which the assessment is to be performed. For example, in the case of object finance exposures, the difference between satisfactory and fair mitigation instruments for assessing the political and legal environment or between satisfactory and fair insurance coverage for assessing insurance against damages may require further clarification.

Under the foundation IRB approach, the proposed credit conversion factor (CCF) for commitments is set at 75% regardless of the maturity of the underlying facility (paragraph 281). This compares with CCFs under the standardised approach of 20% or 50% for commitments with original maturities of up to one year or more than one year respectively (paragraph 56). By contrast, a consistent treatment for short-term self-liquidating trade letters of credit is proposed under both approaches (paragraphs 58 and 284). The reasons, if any, for applying lower CCFs for commitments under the standardised approach than under the IRB approach, should be explained.

The use of the word “may” in paragraph 216 is misleading. It should be made clear that banks that use the advanced IRB approach “must” provide own estimates of PD, LGD and EAD. Although the heading of paragraph 208 reads “definition”, the terms “retail receivable” and “corporate receivable” are not in fact defined in paragraphs 209 and 210.

Securitisation

The ECB acknowledges the substantial progress that has been achieved in the area of securitisation in particular, although some issues may warrant further consideration. With respect to the incentive structure, the proposed framework does not always yield the desired results. For example, low rated tranches (i.e. BB and BB-) attract a substantially lower capital charge under the standardised approach than under the IRB approach.[14] This uneven relation between capital charge and degree of risk sensitivity is even more pronounced when the proposed simplified standardised approach (Annex 9) is used in the assessment. Adverse incentives may therefore prevail and high risk exposures may be taken on through innovative and complex instruments by banks that have relatively less sophisticated risk management systems. This argument is reinforced by the fact that securities markets offer a much more flexible platform to react to such incentives when compared to the general choice of the approach to adopt (i.e. the IRB versus the standardised approach), which may be more of a strategic decision. Cases where the

14 At the other end of the spectrum, high rated tranches attract a relatively higher weight.

capital charge is not commensurate with the risk sensitivity and sophistication may need to be revisited in order to ensure that the appropriate incentive structure is in place.

The proposed rules on securitisation have become very detailed. This is due partly to the need to establish a comprehensive framework as well as the complexity of securitisation transactions. In this context, the complexity of these rules could be reduced by relying less heavily on income and expenses stemming from assets, namely "excess spread", as defined in paragraph 512, and "future margin income" (FMI), as defined in paragraph 203. Within the framework of securitisation, FMI shall be deducted from Tier 1 capital (paragraph 523) and is explicitly excluded from calculating a "cap" (paragraph 554), which sets upper limits for capital charges. In contrast, the treatment of qualifying revolving retail exposures allows FMI to effectively cover 75% of expected losses (paragraph 300). In addition, the securitisation framework introduces the notion of "excess spread", which is relevant for the credit conversion factor (CCF) of specific revolving securitisation transactions and those that include controlled early amortisation provisions. Although the importance of future income and expenses in a comprehensive assessment of risk is, of course, acknowledged, there may be benefits in limiting the technical details when addressing these aspects until a more comprehensive and consistent treatment can be introduced that applies to all exposure classes.

The proposals for a capital treatment of securitisation transactions are closely linked to those on credit risk mitigation (CRM) techniques and this is welcomed as such linkages tend to enhance the consistency of the overall framework. However, in individual cases, such cross-references may require further consideration. Within the framework of securitisation, paragraph 544 refers to "the standardised approach for CRM" for a definition of the eligible range of collateral in a securitisation transaction. This could be understood to mean that equities and bonds of the originating bank or claims against firms that form part of the securitised asset pool would also be acceptable. However, a narrower recognition of collateral may be justified. The value of collateral might be questioned in particular in transactions that use claims against a given company both as collateral and as an underlying asset. In another context, the wording in paragraph 517 (c) concerning eligible guarantors for synthetic securitisations refers to paragraph 142 and appears to mean that the downgrade of a financial institution (e.g. an insurance company) to "single A" would render void any protection that is provided. This could entail substantial changes to the capital requirements of banks whenever an insurance company is downgraded. At the same time, banks may have limited scope to react if the protection seller cannot be forced to pass on the exposure to an eligible guarantor.

Under the IRB approach a bank would be permitted to take into consideration possible overlaps from duplicated coverage given the provision of several types of facilities, and to hold capital only once for the position covered by the overlapping facilities (paragraph 602). Similar flexibility should be provided for under the standardised approach and for overlapping exposures.

Operational risk

The incentive structure associated with the calibration of the capital requirements for the basic indicator and the standardised approach could be improved. Although the basic indicator and the standardised approach represent progressive approaches within the range of the proposed treatments, which is also reinforced by the fact that eligibility criteria are, quite rightly, not used in the basic indicator approach,[15] there are no built-in capital incentives since both approaches have been calibrated to lead to roughly the

15 *By contrast, eligibility criteria are used in the standardised approach (paragraph 624).*

same capital charge (12% of current minimum capital). Thus, incentives may only stem from the types of activity a bank undertakes, as the betas of the standardised approach range between 12% and 18%, depending on the business line, compared with an alpha of 15% proposed for the basic indicator approach. The lack of incentives may lead to capital arbitrage and opportunities for cherry picking. Banks with higher risk profiles engaged in activities for which a higher beta is provided will be induced to opt for the basic indicator approach, whereas banks with lower risk profiles will be induced to opt for the standardised approach. The latter may be desirable in the case of small banks concentrated in low operational risk activities, such as retail banking. However, unless they fulfil the qualifying criteria for the standardised approach, banks with low operational risk profiles will be obliged to apply the basic indicator approach. This may become a further obstacle to ensuring that banks of higher risk are confronted with a higher capital charge. From a longer-term perspective, the ECB would therefore support further work on calibration to ensure that the appropriate incentives exist for choosing between the basic indicator and the standardised approach, especially in view of the fact that the latter approach is expected to be used more widely in the EU than in other G10 countries. In the short run, anomalies deriving from the proposed incentive structure should be dealt with under Pillar II. To this end, the ECB would welcome the insertion of a specific reference to the need to be pro-active in dealing with such cases in the final rules text, by expanding the relevant paragraph on operational risk under Pillar II (paragraph 723).

The reference to internationally active banks with significant risk exposures (paragraph 610) should be modified[16] to make it clear that these banks will be expected to use more advanced approaches. The corresponding reference in the CP2, which states that “while the basic indicator approach might be suitable for smaller banks with a simple range of activities, the Committee expects internationally active banks to use a more sophisticated approach”, could also be used in the CP3.

The definition of gross income (as currently proposed in paragraph 613) is incomplete and may leave room for misinterpretation and divergent implementation. It should be made clear that gross income is to be calculated before the deduction of operating expenses (general administrative expenses in the EU context). It is proposed that a reference to the main sub-components of gross income, as can be found in earlier documents,[17] should also be made in the final New Accord. In this context, gross income is defined as net interest income (interest received minus interest paid) + net non-interest income (comprising (i) fees and commissions receivable less fees and commissions payable, (ii) the net result from financial operations, and (iii) other income). This reference would, on one hand, ensure consistency with definitions of gross income given in earlier BCBS documents and, on the other hand, prevent possible divergent implementations owing to the unintended lack of clarity in the current definition. Similarly, the definition of gross income in the simplified standardised approach (Annex 9, paragraph 64) should also be amended. Guidance is needed on the calculation of gross income for operational risk purposes in specific cases, such as mergers and de-mergers or when gross income is negative (which may be the case for a specific business line such as trading).

Trading book issues

The use by banks of marking to model methodologies in order to determine their trading book positions should, in addition to the criteria set in paragraph 653, be subject to regular review by the internal and external auditors.

16 *The current draft makes a vague reference to being “appropriate for the risk profile and sophistication of the institution”.*

17 *E.g.: Consultative proposals on operational risk as a supporting document to the New Basel Accord (CP2), January 2001; Working paper on the treatment of operational risk, September 2001; and Operational risk rules paper, February 2002.*

Pillar II

A clearer reference to the limits on credit risk concentration that should be defined in relation to the banks' capital, total assets or, where adequate measures exist, to its overall risk level (paragraph 733) would be welcomed. The EU treatment of credit risk exposures, such as in large exposures, may provide useful guidance to the BCBS in this field.

The various issues under the supervisory review (Section C of Part 3) are not addressed in a balanced way. Notwithstanding the importance of having detailed rules, there seems to be excessive detail on securitisation and related elements (such as the supervisory action for banks found to have provided implicit support). Given the importance of the issue, the relevant text could be streamlined by including a reference to a more detailed technical supporting document (as in the case of interest rate risk).

Pillar III

The ECB agrees with the proposed frequency of information disclosure on a semi-annual basis (paragraph 767), while Tier 1 capital, total capital adequacy ratios and risk exposures prone to rapid changes are to be reported on a quarterly basis. However, a reference to a timeframe within which the BCBS expects banks to disclose this information may promote convergence in the timing of disclosure requirements.

The disclosure of capital buffers, determined either through stress-tests under the IRB approach or through other methods, accompanied by quantitative information, would, as a means to combat pro-cyclicality, provide useful additional information not only from a financial stability perspective but also for individual investors.

Quantitative information about banks' phased roll-outs and partial use of approaches in the context of credit risk and operational risk should be accompanied by qualitative information on the timeframe within which the bank expects to roll out the more advanced approaches across all material entities and business lines.

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